

**STATE OF WASHINGTON  
OFFICE OF THE INSURANCE  
COMMISSIONER**

FINANCIAL EXAMINATION



OF


**National Merit Insurance Company  
Bellevue, Washington**

NAIC CODE 39004  
DECEMBER 31, 2002

Exhibit A

**CHIEF EXAMINER AFFIDAVIT**

I hereby certify I have read the attached Report of the Financial Examination of National Merit Insurance Company of Bellevue, Washington. This report shows the financial condition and related corporate matters as of December 31, 2002.

  
\_\_\_\_\_  
Patrick H. McNaughton  
Chief Examiner

10-19-04  
Date

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Seattle, Washington  
September 19, 2004

The Honorable Mike Kreidler, Commissioner  
Washington State Office of the Insurance Commissioner (OIC)  
Insurance 5000 Building  
5000 Capital Blvd.  
Tumwater, WA 98504-0255

Dear Commissioner:

In accordance with your instructions, and in compliance with the statutory requirements of RCW 48.03.010, an examination was made of the corporate affairs and financial records of

**NATIONAL MERIT INSURANCE COMPANY**

of

Bellevue, Washington

hereinafter referred to as "NMIC" or the "Company," at the location of its home office, 15805 NE 24<sup>th</sup> Street, Bellevue, Washington. This report is respectfully submitted showing the financial condition of the Company as of December 31, 2002.

## **SCOPE OF THE EXAMINATION**

This examination covers the period January 1, 1997 through December 31, 2001, carried forward through December 31, 2002, and comprises a comprehensive review of the accounts and records of the Company. The examination followed the statutory requirements contained in the Washington Administrative Code (WAC), Revised Code of Washington (RCW), and the guidelines recommended by the National Association of Insurance Commissioners (NAIC) Financial Condition Examiners Handbook. The examination included identification and disposition of material transactions and events occurring subsequent to the date of examination that were noted during the examination.

Corporate records along with external reference materials from the NAIC and the Internal Revenue Service along with various aspects of the Company's operating procedures and financial records were reviewed and tested during the course of this examination and are commented upon in the following sections of this report. In addition, the Company's certified public accountant's and internal audit work papers were reviewed and utilized, where possible, to facilitate efficiency in the examination.

## **INSTRUCTIONS**

The examiners reviewed the Company's filed 2002 NAIC Annual Statement as part of the statutory examination. This review was performed to determine if the Company completed the Annual Statement in accordance with the NAIC Annual Statement Instructions, and to determine if the Company's accounts and records were prepared and maintained in accordance with Title 48 RCW, Title 284 WAC and the NAIC's Accounting Practices and Procedures Manual.

Based on our materiality threshold, no adjustments were required. Reclassification and adjusting entries are shown for informational purposes only. The following summarizes the exceptions noted while performing this examination.

### **1. Misclassification of Taxes, Licenses and Fees**

The Company incorrectly classified Washington State sales tax in the 2002 NAIC Annual Statements as Other Expenses. Washington State sales tax should be recorded in the account Taxes, Licenses and Fees.

The NAIC Annual Statement Instructions require that states taxes, licenses and fees be included in the line item "Incurred but unpaid investment and underwriting taxes, licenses and fees."

The total amount misclassified as of December 31, 2002 was \$4,337.

**The Company is instructed to properly classify Washington State sales tax in the NAIC Annual Statements as required by RCW 48.05.250 and the NAIC Annual Statement Instructions. In order to properly classify Washington State sales tax, the following reclassification is needed:**

|                          | Debit   | Credit  |
|--------------------------|---------|---------|
| Other Expenses           | \$4,337 |         |
| Taxes, Licenses and Fees |         | \$4,337 |

Subsequent to the date of this examination and prior to the last day of field work, the Company made these reclassification entries.

## **2. Misclassification of Drafts Outstanding**

The Company incorrectly classified liabilities for un-cashed drafts outstanding pending escheatment as Amounts Withheld or Retained by Company for Accounts of Others. The 2002 NAIC Annual Statement Instructions requires that liabilities for un-cashed drafts outstanding pending escheatment should be classified as Aggregate Write-ins for Liabilities.

The total amount of the misclassification as of December 31, 2002 was \$25,697.

**The Company is instructed to properly classify un-cashed drafts outstanding in the correct statement account as required by RCW 48.05.250 and NAIC Annual Statement Instructions. In order to properly classify the amount of drafts outstanding in our examination report, the following adjustment was required:**

|  | Debit    | Credit   |
|--|----------|----------|
| Amounts Withheld or Retained by Company<br>For Account of Others | \$25,697 |          |
| Aggregate Write-ins for Liabilities                              |          | \$25,697 |

Subsequent to the date of this examination and prior to the last day of field work, the Company made these reclassification entries.

## **3. Stock Register**

The Company does not maintain a stock register or stock transfer book that tracks changes in ownership of the Company. We reviewed three stock certificates that indicate Unigard Inc., owns all of the authorized and issued shares of NMIC. The examination staff asked to view the Company's stock register to determine if the three certificates represent the only shares outstanding. The Company was unable to produce a stock register, or any other official Company record. It is a customary business practice for a corporation to maintain a stock register to keep track of stock certificates, capital stock issued, dates of changes, changes in treasury stock, and to record future changes in

ownership. RCW 48.05.280 states: "Every insurer shall keep full and adequate accounts and records of its assets, obligations, transactions and affairs."

**The Company is instructed to maintain a stock register in order to meet the full and adequate accounts and records requirement of RCW 48.05.280.**

#### **4. Investment Management Fee**

The Company receives investment management services from Winterthur Investment Management Corporation (WIMCO) an affiliate. The Investment Management Agreement which was approved by OIC requires management fees to be based on actual costs incurred by WIMCO. The Company was not able to provide records to support the costs incurred by WIMCO in providing investment management services to the Company. The Company did provide a summary record on the billing allocation method used by WIMCO which is based on actual costs but without the records and details to support those costs we were not able to determine the reasonableness of the billings charged to the Company.

This is in violation of the Insurer Holding Company Act (RCW 48.31B.030), which states "...the books, accounts, and records of each party...must be so maintained as to clearly and accurately disclose the nature and details of the transactions, including such accounting information as is necessary to support the reasonableness of the charges or fees to the respective parties."

**The Company is instructed to comply with RCW 48.31B.030 by maintaining its books, accounts, and records so that they clearly and accurately disclose the nature and details of the transactions, including such accounting information as is necessary to support the reasonableness of the charges.**

#### **5. Misclassification of Agents' Balance or Uncollected Premiums**

The Company classified all premiums receivable from agents as "billed" in its NAIC Annual Statements. The NAIC Annual Statements Instructions require premium receivables to be recorded into two specific accounts for billed receivables and unbilled receivables as follows:

|           |   |
|-----------|---|
| Billed:   | Premiums and agents' balances in the course of collection                       |
| Unbilled: | Premiums, agents' balances and installments booked but deferred and not yet due |

Over the examination period of January 1, 1997 to December 31, 2002, the Company recorded all premium receivables as billed. RCW 48.05.250 requires annual statement forms to be in general form and context as approved by the National Association of Insurance Commissioners. The misclassification had no impact on surplus.

**The Company is instructed to comply with RCW 48.05.250 and the NAIC Annual Statement Instructions by separating premium receivables into two categories: premiums in the course of collection, which refers to billed and uncollected premiums, and premiums booked and not yet due.**

Subsequent to the date of this examination and prior to the last day of field work, the Company made these reclassification entries.

#### **6. Prior Approval of Cost-Sharing Agreement**

The Company's Cost-Sharing Agreement involved the following affiliates within the Unigard Insurance Company Group: National Merit Insurance Company (NMIC), Unigard Pacific Insurance Company, Unigard Insurance Company (UIC) and Unigard Indemnity Company (UID). The agreement was implemented on January 1, 1998, which was prior to the Commissioner's approval date of April 6, 1999, and prior to its filing of Form D on January 7, 1999. RCW.31B.030(1)(b) states that a service agreement "...involving a domestic insurer and a person in its holding company system may not be entered into unless the insurer has notified the commissioner in writing of its intention to enter into the transaction and the commissioner declares the notice to be sufficient at least sixty days before, or such shorter period as the commissioner may permit, and the commissioner has not disapproved it within that period." The Company implemented its Cost-Sharing Agreement with its affiliates prior to receiving approval from the OIC.

**The Company is instructed to comply with RCW 48.31B.030(1)(b) which requires prior approval of agreements involving persons in its holding company system.**

### **COMMENTS AND RECOMMENDATIONS**

#### **1. Inter-Company Tax Agreement**

The Inter-Company Tax Agreement with the parent company, Unigard, Inc., requires NMIC to prepare its tax return on a stand-alone basis. NMIC is required to file reports and make payments to the parent company on a timely basis in accordance with the Inter-Company Tax Agreement. NMIC was late in paying its first quarter estimated quarterly tax payment of \$251,156 for year 2003.

**It is recommend that the Company settle its tax liabilities and any estimated tax payments with its parent company in a timely fashion in order to comply with the Inter-Company Tax Agreement.**



## **COMPANY PROFILE**

### **History**

National Merit Insurance Company (NMIC) was incorporated as the Rainier Insurance Company on June 18, 1980 under the laws of the state of Washington and began business on December 31, 1980. On March 16, 1984, the name of the Company was changed to National Merit Insurance Company.

### **Territory and Plan of Operation**

NMIC is a direct writer specializing in preferred automobile and homeowners insurance, primarily in Washington State. In addition to Washington, NMIC is also licensed in Idaho and Oregon.

### **Acquisitions, Mergers, Disposals, Dissolutions, Purchases, And Sales**

NMIC was originally organized as a wholly owned subsidiary of Federated American Insurance Company (FAIC). On December 9, 1997, after receiving regulatory approval, UIC purchased all of the outstanding stock of FAIC. Through this transaction, UIC gained control of NMIC, a wholly owned subsidiary of FAIC. On December 10, 1997, FAIC transferred 100% of its interest in NMIC to UIC through an approved dividend transaction.

### **Growth of Company**

The following schedule shows the Company's growth for selected categories as reported in its NAIC annual statements:

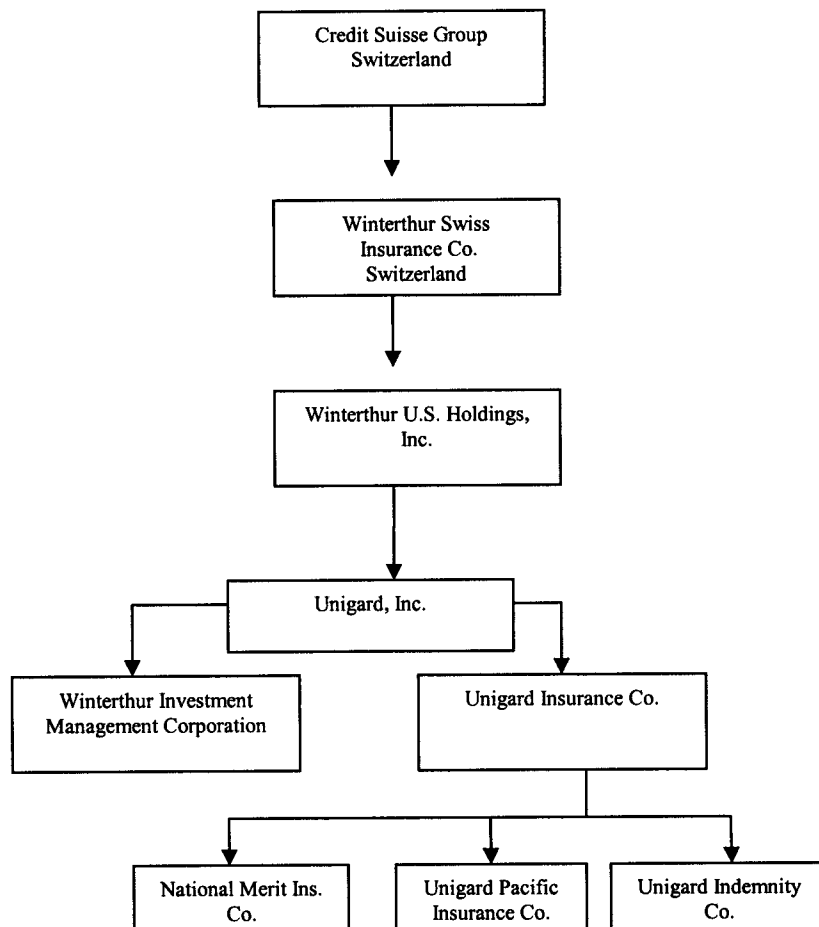
| <b><u>Year</u></b> | <b><u>Net Premiums<br/>Written</u></b> | <b><u>Net Losses<br/>Paid</u></b> | <b><u>Admitted<br/>Assets</u></b> | <b><u>Surplus as Regards<br/>Policyholders</u></b> |
|--------------------|--|-----------------------------------|-----------------------------------|--|
| 1997               | \$ 9,352,611                           | \$ 5,448,152                      | \$ 15,893,222                     | \$ 8,166,650                                       |
| 1998               | 10,396,854                             | 5,695,897                         | 17,023,568                        | 8,796,985  |
| 1999               | 12,033,908                             | 6,695,364                         | 17,967,714                        | 9,179,685  |
| 2000               | 13,464,977                             | 7,566,291                         | 19,366,713                        | 9,497,356  |
| 2001               | 15,223,206                             | 9,068,111                         | 22,889,127                        | 10,274,497   |
| 2002               | 16,790,327                             | 9,564,353                         | 25,343,015                        | 10,258,486   |

## **AFFILIATED COMPANIES**

The Company's outstanding stock is owned by UIC, a subsidiary of Unigard, Inc. All of the voting stock of Unigard, Inc. is owned by Winterthur U.S. Holdings, Inc., a Delaware Corporation and a wholly owned subsidiary of Winterthur Swiss Insurance Company. Winterthur Swiss Insurance Company and its affiliates are members of the Credit Suisse Group. As a member of an insurance holding company system, registration statements are required to be filed in accordance with RCW 48.31B.025 and WAC 284-18-300. Winterthur U.S. Holdings, Inc. filed the registration statements for each year under examination on behalf of the Unigard Insurance Group.

UIC provides all operating services for UPIC, UID, and NMIC with reimbursement pursuant to service agreements between the parties. Winterthur Investment Management Corporation, an affiliate, provides all the investment services for NMIC pursuant to an asset management/investment services agreement dated January 1, 1999.

The following organization chart depicts the direct organizational reporting structure of the Unigard group of companies as of December 31, 2002:



Beginning in 1997, the income tax return of NMIC has been consolidated with Winterthur U.S. Holdings, Inc., and its subsidiaries. The method of allocation between the companies is subject to a written agreement that became effective on December 9, 1997. The terms and conditions of this agreement require an allocation of taxes based upon separate return calculations resulting in a tax charge, or refund, of not more than the

amount each company would have paid, or received, if it had filed a separate return with the Internal Revenue Service.

## **MANAGEMENT AND CONTROL**

### **Ownership**

When the Company was purchased by UIC, 65,000 shares of common stock with a par value of \$10 per share were authorized. The Company was recapitalized through amendments to its Articles of Incorporation effective August 9, 1999. The 65,000 shares of \$10 par value common stock issued and owned by UIC were surrendered in an exchange for 6,500 shares of common stock with a par value of \$100 per share. A stock dividend of 23,500 shares of \$100 par value stock was declared on August 9, 1999, approved by the OIC on August 25, 1999 and transferred on August 31, 1999. After the recapitalization and the stock dividend, the Company remained wholly-owned by UIC which currently owns 30,000 shares of \$100 par value common stock with an authorized capital of \$3,000,000 and all authorized shares are outstanding.

### **Board of Directors**

Article I, Section 1 of the Bylaws states that the business affairs of the Company shall be conducted by a Board of not less than seven (7) or more than seventeen (17) directors. The directors are elected at each annual shareholder meeting and hold office for one year.

The following directors, officers and committee members served the Company as of December 31, 2002:

| <b><u>Directors</u></b> | <b><u>Principal Business Affiliation</u></b>                  | <b><u>Residence</u></b> |
|-------------------------|---|-------------------------|
| Peter Christen          | Chairman, President & CEO<br>Unigard Insurance Group          | Washington              |
| John P. McPeak          | Vice President & CFO<br>Unigard Insurance Group               | Washington              |
| Toni G. Rotz            | Vice President, Personal Lines<br>Unigard Insurance Group     | Washington              |
| L. Arnold Chatterton    | Vice President, Marketing Services<br>Unigard Insurance Group | Washington              |
| Cheryl L. Lang          | Vice President, Human Resources<br>Unigard Insurance Group    | Washington              |

|                    |   |            |
|--------------------|---|------------|
| Jeffrey R. Dehn    | Vice President, Commercial Lines<br>Unigard Insurance Group | Washington |
| Kenneth C. Dedrick | Vice President, Claims<br>Unigard Insurance Group           | Washington |
| Paul D. Neuss      | Vice President, Operations<br>Unigard Insurance Group       | Washington |

Section 4 of the Bylaws provides that the Board shall appoint from among its members an Executive Committee composed of not less than three (3) members, including the President and the Chairman of the Board. The Executive Committee shall have full power to act for the Board ad interim. The following individuals were serving on the Executive Committee as of December 31, 2002:

Peter Christen  
Cheryl Lang  
John McPeak

### **Officers**

#### Elected Officers

Article I, Section 2 of the Bylaws provides that the following key positions of the Company shall be elected by the Board of Directors: Chairman of the Board, President, Executive Vice President, General Counsel, and such number of Senior Vice Presidents and Vice Presidents as the Board may determine. The elected positions as of December 31, 2002 were as follows:

| <u>Name</u>        | <u>Title</u>                                    |
|--------------------|---|
| Peter Christen     | Chairman of the Board & Chief Executive Officer |
| Brian J. DeJong    | President                                       |
| John P. McPeak     | Vice President & Chief Financial Officer        |
| Kenneth C. Dedrick | Vice President, Claims                          |
| Scott A. Kallandar | General Counsel & Secretary                     |
| Toni G. Rotz       | Vice President, Personal Lines                  |

#### Appointed Officers

Article I, Section 3 of the Bylaws provides that the Chief Executive Officer may from time to time designate a Controller, Treasurer, Secretary and any number of Assistant Vice Presidents and Assistant Secretaries. The appointed officers as of December 31, 2002 were as follows:

Scott Kallander  
LeAnn Weese

Secretary  
Treasurer

### **Conflict of Interest**

The Company has policies and procedures to identify any conflicts of interest of the directors, officers and exempt employees. Each officer and director submits a signed conflict of interest statement to the corporate legal department on an annual basis. Each exempt employee submits a signed conflict of interest statement to the corporate legal department every three years. Any reported exceptions that might be considered conflicts of interest are reported to the Board of Directors or its Executive Committee. No material exceptions were noted.

### **Fidelity Bond and Other Insurance**

Winterthur U. S. Holdings, Inc., an affiliate, has a financial institution bond policy that includes coverage for its subsidiaries. The aggregate liability covered by the bond is \$10,000,000 which exceeds the NAIC recommended amount.

Winterthur U.S. Holdings, Inc., also has a program of coverage for its subsidiaries that includes: casualty excess, umbrella, employment practices, professional liability, directors and officer's liability, and fiduciary liability insurance.

The Company's property and general liability coverage is provided through an independent agency, i.e., they are underwritten by insurance companies other than those in the Unigard Group.

### **Officers', Employees', and Agents' Welfare and Pension Plans**

NMIC does not have any employees. The employees of UIC provide all operational services for NMIC as required by the various inter-company contracts and service agreements. The officers of NMIC are also officers of UIC and are eligible for benefits under UIC's plans.

## **CORPORATE RECORDS**

The Company's minutes from the Stockholder, Director, and Committee meetings documented disclosure and approval of the Company's transactions and events. The previous examination report was reviewed by the Company's directors.

### **LOSS EXPERIENCE**

The reserves carried by the Company for unpaid losses and loss adjustment expenses were \$7,924,344 and \$1,956,000 respectively, as of December 31, 2002.

The reserves and an actuarial report prepared by the Company's consulting actuarial firm, Tillinghast-Towers Perrin, were reviewed by the OIC's actuarial staff. Company personnel provided loss and loss adjustment expense development data by accident year and line of business as of December 31, 2002.

Based on the analysis of data through December 31, 2002, the OIC's actuarial staff concluded that the Company's booked reserves for unpaid losses and unpaid loss adjustment expenses as of December 31, 2002 were within a reasonable range. Therefore, the reserves were accepted as shown in the 2002 Annual Statement.

### **REINSURANCE**

All reinsurance agreements in effect as of December 31, 2002 were reviewed and the coverage is summarized as follows:

The Company and its affiliates, UID and UPIC, are collectively reinsured along with its parent company, UIC, under a variety of reinsurance treaties. The following schedule summarizes the companies' ceded reinsurance treaty coverage in force as of December 31, 2002:

| <b><u>Property</u></b> | <b><u>Company Retention</u></b>       | <b><u>Reinsurers' Limits</u></b>  |
|------------------------|---------------------------------------|---|
| First Per Risk Excess  | \$500,000                             | \$1,500,000 excess of retention,  |
|                        | \$750,000 annual aggregate Deductible | \$4,500,000 per occurrence<br>\$3,000,000 for terrorism                                     |
| Second Per Risk Excess | \$2,000,000                           | \$3,000,000 excess of retention,<br>\$6,000,000 per occurrence<br>\$3,000,000 for terrorism |
| Third Per Risk Excess  | \$5,000,000                           | \$5,000,000 excess of retention,<br>\$5,000,000 per occurrence<br>\$5,000,000 for terrorism |

|                               |                                   |   |
|-------------------------------|-----------------------------------|---|
| First Catastrophe Excess      | \$5,000,000                       | 95% of \$5,000,000 excess of retention, ultimate net loss per occurrence  |
| Second Catastrophe Excess     | \$10,000,000                      | 95% of \$10,000,000 excess of retention, ultimate net loss per occurrence |
| <b><u>Casualty</u></b>        | <b><u>Company Retention</u></b>   | <b><u>Reinsurers' Limits</u></b>  |
| First Excess                  | \$500,000 per occurrence          | \$500,000 excess \$500,000 per occurrence                                 |
| Second Excess                 | \$1,000,000 per occurrence        | \$4,000,000 excess \$1,000,000 per occurrence                             |
| Third Excess                  | \$5,000,000 per occurrence        | \$5,000,000 excess \$5,000,000 per occurrence                             |
| Personal Umbrella Quota Share | \$200,000 (20% First \$1,000,000) | 80% First \$1,000,000   |
| Automatic Facultative         |                                   | 100% Next \$4,000,000   |

### **STATUTORY DEPOSITS**

At December 31, 2002, NMIC had the following statutory deposits:

| <b><u>State</u></b> | <b><u>Type of Asset</u></b> | <b><u>Par or Book Value</u></b> | <b><u>Market Value</u></b> |
|---------------------|-----------------------------|---------------------------------|----------------------------|
| Washington          | Bonds                       | \$ 1,100,000                    | \$ 1,282,182               |

### **ACCOUNTING RECORDS AND PROCEDURES**

The Company's accounting functions are performed by UIC at its home office in Bellevue, Washington. Data is processed on UIC's computers using purchased software. Accounting services are also provided by UIC per the inter-company service and management agreement. In addition, the Company receives investment services from WIMCO according to an investment management agreement.

Data for UPIC, UIC, NMIC, and UID are entered into the same general ledger system. Company codes are used to identify and separate each company's data. This system produces a trial balance that can be downloaded into a Lotus spreadsheet and used for

financial reporting. Booke software is used to prepare the NAIC Annual Statement. Investment accounting for marketable securities is processed by Sunguard, a Personal computer (PC) based software package. Sunguard produces the NAIC Annual Statement investment schedules. Supporting details are recorded in the subsidiary ledgers, journals, and tabulations which are maintained by the UIC's accounting department.

### **SUBSEQUENT EVENTS**

The following subsequent events were noted:

1. In March 2003, the Unigard Insurance Company announced its intention to sell NMIC. The sale of NMIC to Response Insurance was announced during the third quarter and was completed during the fourth quarter of 2003.
2. During the fourth quarter of 2003, Winterthur US Holdings, Inc., the parent of Unigard, Inc., announced that it would create a new service company called Winterthur North America (WNA) which will be located in Wisconsin. WNA will provide actuarial, financial, human resource, information technology, legal, and corporate marketing services to companies within Winterthur US Holdings, including UIC and its affiliates. It was announced that about 40 positions in information technology, human resources, and accounting would be eliminated. Most of the financial and accounting functions will be phased out near the end of 2004 and handled by the new service company, WNA. Transition to the new service arrangement will involve significant system conversions, training, and reporting line changes.
3. During the first quarter of 2003, the Company appointed Andreas F. Braendle, (Vice- President of Information Systems) to the Board of Directors. She replaced Paul D. Neuss, the former Vice-President of Operations.

### **FOLLOW UP ON PREVIOUS EXAMINATION FINDINGS**

There were no instructions, comments, or recommendations made during the last examination.

### **FINANCIAL STATEMENTS**

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**NATIONAL MERIT INSURANCE COMPANY**  
**STATEMENT OF ASSETS**  
**DECEMBER 31, 2002**

|  | <u>BALANCE<br/>PER COMPANY</u>  | <u>EXAMINATION<br/>ADJUSTMENTS</u> | <u>BALANCE PER<br/>EXAMINATION</u> |
|--|---------------------------------|------------------------------------|------------------------------------|
| <b>Assets</b>  |                                 |                                    |                                    |
| Bonds  | \$ 17,790,929                   |                                    | \$ 17,790,929                      |
| Cash and short-term investments  | 5,730,153                       |                                    | 5,730,153                          |
| <b>Subtotals, cash and invested assets</b>   | <u>23,521,082</u>               |                                    | <u>23,521,082</u>                  |
| <br>Premiums, agents' balances and installments<br>booked but deferred and not yet due | <br>862,697                     |                                    | <br>862,697                        |
| Federal income tax recoverable and interest thereon                                    | 490,844                         |                                    | 490,844                            |
| Electronic data processing equipment and software                                      | 12,530                          |                                    | 12,530                             |
| Interest, dividends and real estate income due<br>and accrued                          | <br>230,692                     |                                    | <br>230,692                        |
| Receivable from parent, subsidiaries and affiliates                                    | 43,051                          |                                    | 43,051                             |
| Aggregate write-ins for other than invested assets                                     | 182,119                         |                                    | 182,119                            |
| <br><b>Total Assets</b>  | <br><u><u>\$ 25,343,015</u></u> | <br><u><u>0</u></u>                | <br><u><u>\$ 25,343,015</u></u>    |

**NATIONAL MERIT INSURANCE COMPANY**  
**STATEMENT OF LIABILITIES, SURPLUS AND OTHER FUNDS**  
**DECEMBER 31, 2002**

|  |                      |          |                      |
|--|----------------------|----------|----------------------|
| <b>Liabilities</b>   |                      |          |                      |
| Losses   | \$ 7,924,345         |          | \$ 7,924,345         |
| Loss adjustment expenses   | 1,956,000            |          | 1,956,000            |
| Other expenses (excluding taxes, licenses and fees)              | 151,460              |          | 151,460              |
| Taxes, licenses, and fees  | 54,649               |          | 54,649               |
| Unearned premiums  | 4,384,000            |          | 4,384,000            |
| Advanced premiums  | 223,530              |          | 223,530              |
| Amounts withheld or retained by company for<br>account of others | 25,697               |          | 25,697               |
| Remittances and items not allocated                              | 72,955               |          | 72,955               |
| Drafts outstanding   | 291,893              |          | 291,893              |
| <b>Total Liabilities</b>   | <b>15,084,529</b>    |          | <b>15,084,529</b>    |
| <br><b>Surplus and Other Funds</b>                               |                      |          |                      |
| Common capital stock   | 3,000,000            |          | 3,000,000            |
| Gross paid in and contributed surplus                            | 1,632,360            |          | 1,632,360            |
| Unassigned funds (surplus)                                       | 5,626,126            |          | 5,626,126            |
| Surplus as regards policyholders                                 | 10,258,486           |          | 10,258,486           |
| <br><b>Total Liabilities, Surplus and Other Funds</b>            | <b>\$ 25,343,015</b> | <b>0</b> | <b>\$ 25,343,015</b> |

**NATIONAL MERIT INSURANCE COMPANY**  
**STATEMENT OF INCOME**  
**DECEMBER 31, 2002**

|   | <u>BALANCE<br/>PER COMPANY</u> | <u>EXAMINATION<br/>ADJUSTMENTS</u> | <u>BALANCE PER<br/>EXAMINATION</u> |
|---|--------------------------------|------------------------------------|------------------------------------|
| <b>Underwriting Income</b>  |                                |                                    |                                    |
| Premiums earned   | \$ 16,424,047                  |                                    | \$ 16,424,047                      |
| <b>Deductions:</b>  |                                |                                    |                                    |
| Losses incurred   | 12,183,407                     |                                    | 12,183,407                         |
| Loss expenses incurred  | 1,736,252                      |                                    | 1,736,252                          |
| Other underwriting expenses incurred  | 3,866,192                      |                                    | 3,866,192                          |
| Total underwriting deductions   | <u>17,785,851</u>              |                                    | <u>17,785,851</u>                  |
| <b>Net underwriting gain or (loss)</b>  | <u>(1,361,804)</u>             |                                    | <u>(1,361,804)</u>                 |
| <b>Investment Income</b>  |                                |                                    |                                    |
| Net investment income earned  | 865,806                        |                                    | 865,806                            |
| Net realized capital gains or (losses)  | 291,577                        |                                    | 291,577                            |
| <b>Net investment gain or (loss)</b>  | <u>1,157,383</u>               |                                    | <u>1,157,383</u>                   |
| <b>Other Income</b>   |                                |                                    |                                    |
| Net gain or (loss) from agents' or premium<br>balances charged off                          | (8,503)                        |                                    | (8,503)                            |
| Finance and service charges not<br>included in premiums                                     | 131,616                        |                                    | 131,616                            |
| Aggregate write-ins for miscellaneous income  | 13,647                         |                                    | 13,647                             |
| <b>Total other income</b>   | <u>136,760</u>                 |                                    | <u>136,760</u>                     |
| Net income before dividends to policyholders<br>and before federal and foreign income taxes | (67,661)                       |                                    | (67,661)                           |
| Dividends to policyholders  | 0                              |                                    | 0                                  |
| Net income, after dividends to policyholders but<br>before federal and foreign income taxes | <u>(67,661)</u>                |                                    | <u>(67,661)</u>                    |
| Federal and foreign income taxes incurred   | (13,000)                       |                                    | (13,000)                           |
| <b>Net Income</b>   | <u>\$ (80,661)</u>             | <u>0</u>                           | <u>\$ (80,661)</u>                 |

**NATIONAL MERIT INSURANCE COMPANY**  
**CAPITAL AND SURPLUS ACCOUNT**  
**DECEMBER 31, 2002**

|   | <u>BALANCE<br/>PER COMPANY</u> | <u>EXAMINATION<br/>ADJUSTMENTS</u> | <u>BALANCE PER<br/>EXAMINATION</u> |
|---|--------------------------------|------------------------------------|------------------------------------|
| <b>Surplus as Regards Policyholders,<br/>December 31 Prior Year</b>       | <b>\$ 10,274,497</b>           |                                    | <b>\$ 10,274,497</b>               |
| <b>Gains and (Losses) in Surplus</b>                                      |                                |                                    |                                    |
| Net income  | (80,661)                       |                                    | (80,661)                           |
| Change in net deferred income tax   | 26,000                         |                                    | 26,000                             |
| Change in non-admitted assets   | 38,650                         |                                    | 38,650                             |
| <br>Change in surplus as regards policyholders<br>for the year            | <br>(16,011)                   |                                    | <br>(16,011)                       |
| <br><b>Surplus as Regards Policyholders,<br/>December 31 Current Year</b> | <br><b>\$ 10,258,486</b>       | <br><b>0</b>                       | <br><b>\$ 10,258,486</b>           |

**NATIONAL MERIT INSURANCE COMPANY**  
**RECONCILIATION OF CAPITAL AND SURPLUS ACCOUNT**  
**FOR THE FIVE YEARS ENDING DECEMBER 31**

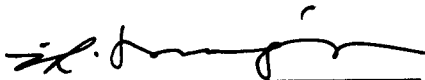
|   | <u>2002</u>          | <u>2001</u>          | <u>2000</u>         | <u>1999</u>         | <u>1998</u>         |
|---|----------------------|----------------------|---------------------|---------------------|---------------------|
| <b>Capital and Surplus as Regards</b>                             |                      |                      |                     |                     |                     |
| <b>Policyholders, December 31 Prior Year</b>                      | <b>\$ 10,274,497</b> | <b>\$ 9,497,356</b>  | <b>\$ 9,179,685</b> | <b>\$ 8,796,985</b> | <b>\$ 8,166,650</b> |
| <br><b>Gains and (Losses) in Surplus</b>                          |                      |                      |                     |                     |                     |
| Net Income  | (80,661)             | 453,401              | 111,736             | 660,881             | 635,931             |
| Change in net deferred income tax                                 | 26,000               | 158,000              |                     |                     |                     |
| Change in non-admitted assets                                     | 38,650               | (141,179)            | (63,869)            | 2,823               | (4,596)             |
| Change in excess of statutory reserves<br>over statement reserves |                      |                      | 269,804             | (281,004)           | (1,000)             |
| Cumulative effect of changes in<br>accounting principles          |                      | 342,200              |                     |                     |                     |
| Capital changes; transfers from surplus                           |                      |                      |                     | 2,350,000           |                     |
| Dividends to stockholders (cash)                                  |                      |                      |                     |                     |                     |
| Surplus adjustments: transfers to capital                         |                      |                      |                     | (2,350,000)         |                     |
| Aggregate write-ins for gains and<br>losses in surplus            |                      | (35,281)             |                     |                     |                     |
| <br>Change in surplus as regards<br>policyholders for the year    | <u>(16,011)</u>      | <u>777,141</u>       | <u>317,671</u>      | <u>382,700</u>      | <u>630,335</u>      |
| <br><b>Capital and Surplus as Regards</b>                         |                      |                      |                     |                     |                     |
| <b>Policyholders, December 31 Current Year</b>                    | <b>\$ 10,258,486</b> | <b>\$ 10,274,497</b> | <b>\$ 9,497,356</b> | <b>\$ 9,179,685</b> | <b>\$ 8,796,985</b> |

### **ACKNOWLEDGMENT**

Acknowledgment is hereby made of the cooperation extended to the examiners by the officers of National Merit Insurance Company during the course of this examination.

In addition to the undersigned, Mike Jordan, CPA, CFE, MHP; Carl Baker, CPA, CISA, AFE; Bert Karau, CPA; Jeanette Liao; Kathy Hicks, CPA; Mitch Coe, CPA; Tarik Subbagh, CPA; D. Lee Barclay, FCAS, MAAA; Eric Slavich; and John Jacobson, AFE; all from the Washington State Office of the Insurance Commissioner, and Timothy Hurley, CFE from Oregon State Office of the Insurance Commissioner participated in the examination and the preparation of this report.

Respectfully submitted,



TIMOTEO L. NAVAJA, CFE, CIE  
Examiner in Charge  
State of Washington

**AFFIDAVIT**

**STATE OF WASHINGTON**

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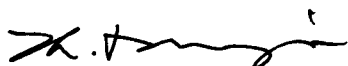
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**COUNTY OF KING**

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Timoteo L. Navaja, being duly sworn, deposes and says that the foregoing report subscribed by him is true to the best of his knowledge and belief.

He attests that the examination of National Merit Insurance Company was performed in a manner consistent with the standards and procedures required or prescribed by the Washington State Office of the Insurance Commissioner and the National Association of Insurance Commissioners (NAIC).

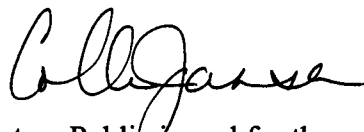


TIMOTEO L. NAVAJA, CFE, CIE

Examiner- In- Charge

State of Washington

Subscribed and sworn to before me this 19<sup>th</sup> day of October, 2004.



Notary Public in and for the  
State of Washington.

